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# Globalization and *tax competition:* implications for *developing countries*

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This article analyses the effects of tax competition on developing countries. Since the 1980s, globalization and greater capital mobility have led many developing countries to adopt the policy of competing with one another to attract capital investment. One of the main forms taken by this competition has been the granting of tax holidays and other tax reductions to investing multinationals. This paper reviews the normative arguments for and against this type of tax competition, from a global perspective. It then examines these arguments in depth from the point of view of developing countries. The conclusion in general is that, since transnational companies would invest in developing countries even if they did not receive tax subsidies, but are able to receive them through a kind of bidding process among developing countries, it would be more advisable for the latter to agree to refrain from granting such subsidies. Lastly, consideration is given to some ways in which cooperation of this sort could be achieved, either regionally or globally (through the World Trade Organization, for example).

# I

## Introduction

The current age of globalization can be distinguished from the previous one (from 1870 to 1914) by the much higher mobility of capital than labour (in the previous age, before immigration restrictions, labour was at least as mobile as capital). This increased mobility has been the result of technological changes (the ability to move funds electronically) and the relaxation of exchange controls. The mobility of capital has led to tax competition, in which sovereign countries lower their tax rates on income earned by foreigners within their borders in order to attract both portfolio and direct investment. Tax competition, in turn, threatens to undermine individual and corporate income taxes, which remain major sources of revenue (in terms of percentage of total revenue collected) for all modern States. The response of both developed and developing countries to these developments has been first, to shift

the tax burden from (mobile) capital to (less mobile) labour, and second, when further increased taxation of labour becomes politically and economically difficult, to cut government services. Thus, globalization and tax competition lead to a fiscal crisis for countries that wish to continue to provide those government services to their citizens, at the same time that demographic factors and the increased income inequality, job insecurity and income volatility that result from globalization render such services more necessary. This paper argues that if government service programmes are to be maintained in the face of globalization, it is necessary to cut the intermediate link by limiting tax competition. However, from both practical and normative considerations, any limits set to tax competition should be congruent with maintaining the ability of democratic States to determine the desirable size of their government.

# II

## International tax competition and the taxation of capital

From its beginnings late in the nineteenth century, the modern State has been financed primarily by progressive income taxation. The income tax differs from other forms of taxation (such as consumption or social security taxes) in that in theory it includes income from capital in the tax base, even if it is saved and not consumed.

Because the rich save more than the poor, a tax that includes income from capital in its base is more progressive (taxes the rich more heavily) than a tax that excludes income from capital (e.g., a consumption tax or a payroll tax). However, the ability to tax saved income from capital (i.e., income not vulnerable to consumption

taxes) is impaired if the capital can be shifted overseas to jurisdictions where it escapes taxation.

Two recent developments have dramatically augmented the ability of both individuals and corporations to earn income overseas free of income tax: the effective end of withholding taxation by developed countries, and the rise of production tax havens in developing countries (Avi-Yonah, 2000). Since the United States abolished its withholding tax on interest paid to foreigners in 1984, no major capital importing country has been able to impose such a tax for fear of driving mobile capital elsewhere (or increasing the cost of capital for domestic borrowers, including the government itself) (Tanzi, 1995 and Gardner, 1992). The result is that individuals can generally earn investment income free of host country taxation in any of the world's major economies (Avi-Yonah and Swartz, 1997; Cohen, 1998 and May, 1996).

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Moreover, even developed countries find it exceedingly difficult to effectively collect the tax on the foreign income of their individual residents in the absence of withholding taxes imposed by host countries, because the investments can be made through tax havens with strong bank secrecy laws (Tanzi, 1995). Developing countries, with much weaker tax administrations, find this task almost impossible. Thus, cross-border investment income can largely be earned free of either host or home country taxation (Kant, 1996 and McLure, 1989).

For example, consider a wealthy Mexican who wishes to earn tax-free interest income from investing in the bonds of an American corporation. All he needs to do is set up, for a nominal fee, a Cayman Islands corporation to hold the bonds. The interest payments are then made to the Caymans corporation without any United States tax withheld under the so-called "portfolio interest exemption" (United States Internal Revenue Code section 871(h)). The individual does not report the income to the Mexican tax authorities, and they have no way of knowing that the Caymans corporation is effectively an "incorporated pocketbook" of the Mexican resident. Nor are the exchange of information provisions of the United States-Mexico tax treaty of any help, because the United States Internal Revenue Service has no way of knowing that the recipient of the interest payments is controlled by a Mexican resident and therefore cannot report this to the Mexican authorities. As a result, the income is earned completely free of tax (the Caymans, of course, impose no income taxes of their own).

When we switch our attention from passive to productive investment, a similar threat to the taxing capacity of both home and host jurisdictions emerges. In the 1990s, competition for inbound investment led an increasing number of countries (103, as of 1998) to offer tax holidays specifically geared to foreign corporate investors (Vernon, 1998 and UNCTAD, 1996). Given the relative ease with which an integrated multinational can shift production facilities in response to tax rates, such "production tax havens" enable multinationals to derive most of their income abroad free of host country taxation (Hines and Rice, 1994 and Altshuler and Newlon, 1993). Moreover, most developed countries (including the United States) do not dare impose current taxation (or sometimes any taxation) on the foreign source business income of their resident multinationals, for fear of reducing the competitiveness of those multinationals against multinationals of other countries (Peroni, 1997). If they

did, new multinationals could be set up as residents of jurisdictions that do not tax such foreign source income (Hines, 1991). Thus, business income can also be earned abroad largely free of either host or home country taxation.

For example, Intel Corporation, a top 10 multinational, has operations in more than 30 countries around the globe. The company states that "[a]n Intel chip developed at a design centre in Oregon, might be manufactured at a wafer fabrication facility in Ireland, packaged and tested in Malaysia, and then sold to a customer in Australia. Another chip might be designed in Japan, fabricated in Israel, packaged and tested in Arizona, and sold in China" (Intel Corporation, 1998). Specifically, outside the United States, Intel has major manufacturing facilities in China, Ireland, Israel, Malaysia, the Philippines and Puerto Rico (Intel Corporation, 1999). Thus, outside the United States, all of Intel's manufacturing facilities are located in countries granting tax holidays. Nor does Intel pay current United States tax on its income from those foreign operations, because under United States law, active income earned by foreign subsidiaries of United States multinationals is not taxed until it is repatriated in the form of dividends, which Intel can delay for many years (Avi-Yonah, 1997). Thus, the effective tax rate on Intel's foreign source income is far below the nominal United States corporate rate of 35%.

If income from capital can escape the income tax net, the tax becomes in effect a tax on labour. Several empirical studies have in fact suggested that in some developed jurisdictions the effective tax rate on income from capital approaches zero, and tax rates on capital have tended to go down sharply since the early 1980s, when exchange controls were relaxed (Owens and Sasseville, 1997 and Rodrik, 1997). As a result, countries that used to rely on the revenues from income tax are forced to increase relatively regressive taxes. The two fastest growing taxes in OECD member countries in recent years have been consumption taxes (from 12% of total revenues in 1965 to 18% in 1995) and payroll taxes (from 19% to 27%), both of which are more regressive than income tax (Owens and Sasseville, 1997). Over the same period, personal and corporate income taxes have not grown as a percentage of total revenues (personal income tax accounted for 26% of total revenues in 1965 and 27% in 1995, while the figures for corporate income tax are 9% and 8% respectively) (Owens and Sasseville, 1997). The total tax revenue as a percentage of GDP in developed countries went up sharply during the same period (from

an average of 28% in 1965 to almost 40% in 1994), and this increase is largely accounted for by the rise of consumption and payroll taxes (World Bank, 1994). Moreover, there is evidence that as the degree of openness of an economy in OECD member countries increases, taxes on capital tend to go down while taxes on labour go up (income tax is imposed on both capital and labour, so that its stability may mask this trend) (Mendoza, Razin and Tesar, 1994 and Mendoza, Milesi-Ferretti and Asea, 1996).

The same trends can be observed in developing countries as well. In non-OECD member countries (outside the Middle East) total government revenues as a share of GDP rose from an average of 18.8% in 1975-1980 to 20.1% in 1986-1992 (World Bank, 1994). This growth was financed primarily by the growth of revenues from value added tax in the same period (from 25.5% of total revenues to 31.8%). At the same time, revenues from both individual and corporate income tax were flat or declined (World Bank, 1994).

### III

## Tax competition and the developing countries

The drawbacks of tax competition for developed countries are relatively clear, because such countries have an elaborate social insurance safety net that requires a high level of government expenditure and that is threatened by tax competition (Leibfritz and others, 1995). But how does tax competition affect developing countries?

First, it should be pointed out that developing countries need the revenues at least as much as developed countries do, if not more. A common misperception is that only OECD member countries are confronted by a fiscal crisis as a result of the increasing numbers of elderly people in the population. In fact, the increase in dependency ratios (the ratio of the elderly to the working population) is expected to take place in other geographic areas as well, as fertility rates go down and health care improves (World Bank, 1994). Outside OECD and the transition economies, the dependency ratio starts in the single digits in the 1990s, but rises to just below 30% by 2100 (McLure, 1996). Moreover, while outside OECD and the transition economies direct spending on social insurance is much lower, other forms of government spending (e.g., government employment) effectively fulfil a social insurance role. In Latin America, for example, direct government spending on social insurance is much lower than indirect spending through government employment and procurement programmes (Subbarao and others, 1997).

Moreover, it seems strange to argue that developing countries need tax revenues less than developed countries because they have less developed social

insurance programmes. If one accepts the normative case for social insurance, it applies to developing countries with even greater force because of widespread poverty, which means that losing a job can have much direr consequences (UNDP, 1997). But the need for revenues in developing countries goes far beyond social insurance. In some developing countries, revenues are needed to ensure the very survival of organized government, as the Russian experience demonstrates (*The Economist*, 1998). In other, more stable developing countries revenues are needed primarily to provide for adequate education (investment in human capital), which many regard as the key to promoting development (Sen, 1997). For example, the United Nations has estimated that for only US\$ 30 billion to US\$ 40 billion, all people in the world can obtain basic social services, such as elementary education (UNDP, 1997). Given current trends in foreign aid, most of these funds have to come from developing country governments (United Nations, 2001).

Second, the standard advice by economists to small open economies is that they should refrain from taxing foreign investors, because such investors cannot be made to bear the burden of any tax imposed by the capital importing country (Razin and Sadka, 1991). Therefore, the tax will necessarily be shifted to less mobile factors in the host country, such as labour and/or land, and it is more efficient to tax those factors directly. But while this argument seems quite valid as applied to portfolio investment, it seems less valid in regard to foreign direct investment (FDI), for two

reasons. First, the standard advice does not apply if a foreign tax credit is available in the home country of the investor, which frequently would be the case for FDI (Viherkentta, 1991). Second, the standard advice assumes that the host country is small. However, an extensive literature on multinationals suggests that typically they exist in order to earn economic rents (Hennart, 1991). In that case, the host country is no longer “small” in the economic sense. That is, there is a reason for the investor to be there and not elsewhere. Therefore, any tax imposed on such rents (as long as it is below 100%) will not necessarily drive the investor to leave even if it is unable to shift the burden of the tax to labour or landowners.

This argument clearly holds in the case of rents that are linked to a specific location, such as natural resources or a large market. But what if the rent can be earned in a large number of potential locations (Dunning, 1988)? In this case, the host country will not be able to tax the rent if the multinational can credibly threaten to go elsewhere, although once the investment has been made the rent can be taxed. This situation, which is probably the most common (Hennart, 1991), would require coordinated action to enable all host countries to tax the rent earned within their borders. Some possibilities for such action are described below.

This relates to the final argument, which is that host countries need to offer tax incentives to be competitive. An extensive literature has demonstrated that taxes do in fact play a crucial role in determining investment location decisions (Bond, 1981; Boskin and Gale, 1987 and Hines, 1999). But all of these studies emphasize that the tax incentives are crucial *given the availability of such incentives elsewhere* (Guisinger and others, 1985). Thus, it can be argued that given the need for tax revenues, developing countries would in general prefer to refrain from granting tax incentives, if only they could be assured that no other developing country would be able to grant such incentives (Avi-Yonah, 2000).

Thus, restricting the ability of developing countries to compete in granting tax incentives does not truly restrict their autonomy or counter their interests. That is the case whenever they grant the incentive only for fear of competition from other developing countries, and would not have granted it but for such fear. Whenever competition from other countries drives the tax incentive, eliminating the competition does not hurt the developing country, and may aid its revenue-raising efforts (assuming it can attract investment on other

grounds, which is typically the case). Moreover, under the proposals described below, developing countries remain free to lower their tax rates generally (as opposed to granting specific tax relief aimed at foreign investors).

Two additional points need to be made from a developing country perspective. The first concerns the question of tax incidence. Since the tax competition that is most relevant to developing countries concerns the corporate income tax, it is important to attempt to assess the incidence of that tax in evaluating the effects of collecting it on the welfare of the developing country. Unfortunately, after decades of analysis, no consensus exists on the incidence of corporate tax. While the older studies have tended to conclude that the tax is borne by shareholders or by all capital providers, more recent studies have suggested that the tax is borne to a significant extent by consumers or by labour (Pechman, 1987 and United States, Department of the Treasury, 1992). Another possibility is that the tax on established corporations was borne by those who were shareholders at the time the tax was imposed or increased, because thereafter it is capitalized into the price of the shares (Pechman, 1987). It is unlikely that this debate will be decided any time soon (in fact, the incidence may be shifting over time, especially as globalization may enable corporations to shift more of the tax burden to labour). However, from the perspective of a developing country deciding whether to collect taxes from a multinational, three out of the four possible alternatives for incidence (current shareholders or capital providers, old shareholders, and consumers) are largely the residents of other jurisdictions, and therefore from a national welfare perspective the developing country gains by collecting the tax. And even if some of the tax is shifted to labour in the developing country, it can be argued that as a matter of tax administration it is more efficient (as well as more politically acceptable) to collect the tax from the multinational than to attempt to collect it from the workers.

Finally, it should be noted that a developing country may want to collect taxes from multinationals even if in general it believes that the private sector is more efficient in using the resources than the public sector. That is because in the case of a foreign multinational, the taxes that the developing country fails to collect may indeed be used by the private sector, but in another jurisdiction, and therefore not benefit the developing country. One possible solution, which is in fact employed by developing countries, is to refrain from taxing multinationals while they re-invest



domestically, but tax them upon remittance of the profits abroad. However, such taxation of dividends and other forms of remittance is subject to the same tax competition problem that we discussed above. Thus, it

would appear that overcoming the tax competition problem is in most cases in the interest of developing countries, and the question remains how to do so in the face of the collective action problem described above.

## IV

### What can be done about tax competition?

The tax competition problem is thus essentially a problem of coordination and trust. Each jurisdiction would prefer to tax investors from abroad to gain the revenue, but is afraid that by doing so it would drive the investors to other jurisdictions that do not tax them. If there was a way to coordinate actions among the relevant jurisdictions, they all could gain added revenues without running the risk of losing the investment.

A good illustration of how this dynamic works is the history of German taxation of interest income. In 1988, Germany introduced a 10% withholding tax on interest paid to bank depositors, but had to abolish it within a few months because of the magnitude of capital flight to Luxembourg. In 1991, the German Federal Constitutional Court held that withholding taxes on wages but not on interest violated the constitutional right to equality. The Government thereupon reintroduced the withholding tax on interest, but made it inapplicable to non-residents (Muten, 1994). Non-residents may, however, be Germans investing through Luxembourg bank accounts. To cope with this problem, the Germans have led a European Union effort to introduce a 20% withholding tax on all interest payments to European Union residents (European Union, 1998). However, both Luxembourg and the United Kingdom have so far blocked the adoption of this plan, arguing that it will lead to a flight of investors to Switzerland or the United States (Annells, 1998).

Thus, the key to finding a solution to the tax competition problem is to attack it on a broad multilateral basis, through an organization such as OECD. Under current conditions, OECD is the natural choice for leading such coordinated actions against tax competition, for three reasons. First, for individual investors to earn decent returns on their capital without incurring excessive risks, they need to invest in an OECD

member country. Tax havens do not offer adequate investment opportunities, and developing countries are generally considered too risky for portfolio investment (other than through mutual funds, which do not offer tax avoidance opportunities). Thus, if all OECD members enforced taxation of portfolio investment, it could be subject to tax without requiring cooperation from the tax havens.

Second, about 85% of the world's multinationals are headquartered in OECD member countries. This is likely to continue to be the case for a while, because OECD members offer stable corporate and securities law protection to investors that is lacking in other countries. Thus, if all OECD members agreed on a coordinated basis to tax their multinationals currently on their income from abroad, most of the problem of tax competition from direct investment could be solved.

Third, OECD has the required expertise (its model tax treaty is the global standard) and has already started on the path of limiting tax competition. In 1998, it adopted a report entitled *Harmful Tax Competition: An Emerging Global Issue* (OECD, 1998). This report is somewhat limited, because it only addresses tax competition for financial activities and services (as opposed to, e.g., Intel's manufacturing plants). It also does not address the taxation of investment income. But it represents an extremely useful first step, and proof that a consensus can be reached on the tax competition issue (Luxembourg and Switzerland abstained, but did not dare veto the adoption of the report by the other 27 members of OECD).

A useful distinction is drawn by OECD between tax competition in the form of generally applicable lower tax rates, and tax regimes designed to attract foreign investors. This distinction is both normatively and pragmatically sound: restricting tax competition should

not and cannot mean that voters in democratic countries lose their right to determine the size of the public sector through general tax increases or reductions. But it does mean that countries should not provide windfalls for foreign investors at the expense of the ability of other countries to provide those public services their residents desire. Such limitations are particularly appropriate because those foreign investors themselves often reside in countries providing a high level of services, and yet refuse to pay the tax price that providing such services entails.

Depending on OECD for solving the tax competition problem suffers from one major drawback: developing countries are left out, and may perceive actions by OECD as a cartel of rich countries operating at their expense. In fact, as pointed out above, it is unlikely that tax competition benefits developing countries, which can also use the tax revenues they give up to attract foreign investors. If all developing countries could be prevented from competing in this fashion, they all could gain. But in the longer run, it may be better to entrust the fight against harmful tax competition to WTO, in which developing countries are adequately represented. This would also solve the problem of what to do about the 15% of multinationals that are not headquartered in OECD member countries (a percentage that can be expected to grow if OECD indeed moves to restrict tax competition for its multinationals).

To sum up: as a result of globalization and tax competition, tax rules can no longer be set by countries acting unilaterally or by bilateral tax treaties. In a world in which capital can move freely across national borders and multinationals are free to choose among many investment locations, the ability of any one country (or any two countries in cooperation) to tax (or otherwise regulate) such capital is severely limited. Any such unilateral attempt will be undercut by other countries, and will probably not be even attempted in the name of preserving national competitiveness. Thus, a multilateral solution is essential if the fundamental goals of taxation or other regulation are to be preserved. Private market activities that span the globe can only be regulated or taxed by organizations with a similar global reach.

This paper has attempted to outline some of the ways in which such global governance can be achieved in the area of capital income taxation. Achieving this goal will not be easy, given the expected resistance of both private actors eager to preserve their freedom from taxation and of governments concerned about preserving their sovereign ability to set their own tax rules. But it is not impossible. Moreover, since preserving the ability of nations to tax income from capital is essential to the achievement of several crucially important goals (like the preservation and development of adequate government services to the poor), it must be tried.

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